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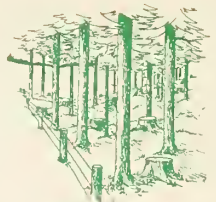
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MANAGING YOUR WOODLAND

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HOW TO DO IT GUIDES

C & R-PREP.



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LOSSES OF TIMBER FROM FIRE, WINDSTORM, OR OTHER CASUALTY

If your timber was damaged or destroyed by fire, windstorm, ice damage, or flood, it is a casualty loss, and you may be entitled to claim a deduction on your income tax return. We have attempted to explain here the treatment of casualty losses as they may affect your federal income tax return.

Since timber is an asset, growing in volume as well as in value, the gain or loss incurred from ownership and management requires good records and careful analysis for income tax consideration. Income tax problems begin the day a timberland owner acquires his ownership. This discussion begins at that point.

This is not an official statement of the Internal Revenue Service, but has been reviewed for accuracy by one of their timber agents. This is a general statement to provide a broad understanding of the way to handle timber casualty losses for federal income tax purposes. Some details of the income tax law on casualty losses must be clarified by professionals in this field. Take your detailed problem to a revenue agent.

THE BASIS OF PROPERTY

To become oriented to the language of income tax law, it is first necessary to fully understand the meaning of the word "basis", as used therein. This word is repeatedly used in the Code and Regulations and will be repeatedly used in this discussion since it is a factor in the computation of realized gain or loss and taxable income.

As a general rule, the basis of property is its cost. The primary consideration in determining a casualty loss from a woodland, or a stand of trees, is the actual cost to the owner of the timber involved. The cost of the land must be kept separate from the cost of the timber or trees because the land

cannot be depreciated or depleted for income tax purposes.

The basis of property includes not only the direct purchase price but also such indirect costs of acquisition as expenditures for title search, recording fees, brokers' commissions, or other costs of acquiring the property. In the event a tract of timber is purchased, for example, the basis may include such costs as amounts expended for the purchase cruise, running boundary lines, or initial appraisals, so long as they were incurred in the acquisition of the tract and were not previously used as income tax deductions. Annual property taxes on the tract can also be capitalized as part of the cost if not deducted annually.



FOR FURTHER INFORMATION CONSULT YOUR LOCAL FORESTER



ALLOCATION OF COST OR BASIS

The acquisition of a timber property will often involve mixed assets such as land, buildings, and other improvements or subsurface rights, etc. The total cost of the entire property must be allocated among the several classes of assets involved to give each its own cost or basis for future calculation of gain or loss. Different classes of assets are given different tax treatment under the Internal Revenue Code. For example, the basis of timber is recoverable through depletion deductions while the basis of equipment is returned through allowances for depreciation. Land and certain other permanent assets are subject to neither depletion nor depreciation and their basis is recoverable only through sale or other disposition.

The general rule is that allocation of cost among the various assets is to be based upon the relative value of each asset to the value of the whole.

As an example:

The cost of 100 acres of timberland containing 1 million bd.ft. of timber is	\$12,000
Land value based on current sales or other facts	<u>2,000</u>
If no other assets are involved, value of timber is	\$10,000

Reduced to a cost or basis per unit, it is \$10 per thousand bd.ft.

If the tract contains stands of varying condition, separate allocations should be made to merchantable timber, submerchantable timber, and to reproduction. The allocations must be realistic to reflect relative values and kept in accounts that can be maintained with reasonable ease and accuracy as growth or depletion occurs.

Assume the basis in the timber were determined to be \$10 per thousand bd.ft., as in the example. If a partial cut were to be made removing 40% of the volume and 70% of the value, according to the marking rule to be used, two timber accounts would be established. Forty percent of the total value would be allocated to the timber cut, while the remainder would be allocated to the residual timber account as follows:

	Quantity	Unit Rate	Total
	M Feet	(Per M)	Value
Timber to be cut	400 (40%)	\$17.50	\$7,000 (70%)
Residual	600 (60%)	5.00	<u>3,000 (30%)</u>
	1,000	10.00	10,000

This type of allocation requires establishment of a true and factual relationship between the values of the timber to be cut and the residual timber, and further demands that the marking rule be closely followed during the first cutting cycle. Any real deviation from the marking rule will, of course, tend to change the volume and the allocated costs of the timber in both accounts.

The value of bare timberland will vary with the general factors of location and accessibility, growing capacity, condition as to ground cover, and topography. Sales of bare timberland, as such, are not of frequent occurrence since it is seldom that timberland is entirely bare. More often, some other elements of value, such as roads or reproduction, are also present. However, adequate information can be developed to give reasonable indication as to bare land values which can be employed for the purpose of allocation.

When a portion of a timber stand is lost the deductible casualty loss is

the basis of each unit of timber multiplied by number of units destroyed. If, in a blowdown, the full basis of some of the down timber is recovered by salvage sale, those units would have no deductible casualty loss even if sold for less than full market value of the same timber standing. But the basis in the units of volume not saleable, because of breakage or other factors, is a deductible casualty loss.

TIMBER QUANTITY

Upon acquisition of a tract of timber, an estimate must be made of the number of units of timber known or believed to exist upon the tract as of that time. This estimate must state, as accurately as possible, the number of units of timber that the tract would produce upon the acquisition date if 100 percent of the merchantable timber were cut and utilized according to the prevailing standards of utilization. This estimate is normally expressed in terms of board measure, log scale. However, it may also be expressed in lineal feet of poles and piling or cords of pulpwood, depending upon the nature of the stand.

If at any time it should develop that there are more or less units of timber remaining in the tract than are reflected in the timber account, a corrective adjustment is immediately in order. The adjustment is made with the objective of restating the timber quantity in the account to reflect the corrected anticipated recovery. An adjustment of this type may result from such factors as growth, changes in standards of utilization, cruising error, or other reasons. The net effect of such corrective adjustments to timber quantity is a change in the unit basis or depletion rate, rather than an adjustment of the total cost.

Where applicable and practical, timber owners must maintain separate accounts for areas consisting primarily of trees of insufficient size to be currently merchantable. This is true whether the young growth occurs in separate and distinct areas or is intermingled with merchantable timber in an existing block. Logically, it would be unsound to include the basis of this submerchantable timber in a merchantable timber account, since such basis is recoverable only when this small timber reaches harvest size and is cut.

Quantities lost through casualty, such as fire, epidemic diseases and insects, or windthrow must be deducted from the timber account in the year of loss. However, such losses should only be deducted to the extent of actual loss after giving consideration to the quantity of timber subject to subsequent salvage. The mere fact that a quantity of timber was fire-killed or windthrown does not preclude the possibility of substantial recovery through early logging. Therefore, the amount of loss will be limited to the actual net loss in volume.

The deductible casualty loss is the basis in that net volume loss.

SUMMARY OF CASUALTY LOSS TREATMENT

You must have a basis in the timber lost before you have a deductible casualty loss when your forest stand is destroyed. This is determined by allocating the actual cost of acquisition between the timber and other kinds of assets included. The basis (cost) for each unit is found by dividing the net cost allocated to the stand of trees by the number of units in the stand. The deductible casualty loss for income tax purposes is the basis in the units of timber actually lost beyond subsequent salvage operations. A real loss of value is sustained when timber is destroyed but the amount of this loss over and above the net cost or basis in the units lost is not a deductible casualty loss.

OTHER TIMBER COST ACCOUNTING FOR INCOME TAX CONSIDERATIONS

By regulation, each taxpayer claiming, or expecting to claim, a deduction from income for depletion of timber must file a completed Form T (Timber) with his income tax return for the taxable year. This form is available from the Internal Revenue Service and is designed to assist the taxpayer in supplying information necessary for the audit of his timber accounts.

In general, the Code requires that costs which are capital in nature must be charged to a capital account while true current expenses must be deducted in the year incurred. However, the Code and the regulation also provide that, with respect to unimproved and unproductive real property, otherwise deductible carrying charges and development expenses may be capitalized at the election of the taxpayer. Included in the category of carrying charges are normal otherwise deductible current expenditures such as annual property taxes, interest on money borrowed to finance the purchase or interest on a mortgage, and expenditures made for fire protection. Development expenses are those incurred during the period in which portions of the tract are not producing net income but are being given silvicultural treatment for a future harvest. Development expenses may therefore include costs of girdling or poisoning weed species, fencing or pruning and thinning; but such expenses must be offset to the extent of any incidental income that is received from the operation.

The election to capitalize otherwise deductible carrying costs is applicable only to unimproved and unproductive real property so that upon becoming active from the standpoint of income production, a tract or account may no longer be given the optional treatment. Attention is also directed to the fact that while the regulation permits the capitalization of certain otherwise deductible costs, it does not permit the current deduction of expenditures that are purely capital in nature, such as reforestation costs.

Concerning the costs of reforestation, the regulation provides that amounts paid or incurred in connection with the planting of timber shall be capitalized and recovered through depletion allowances. This rule also applies to costs of planting for Christmas tree purposes. Examples of such expenditures are costs incurred in the preparation of the site for planting or for natural seeding and the cost of seedlings. The foregoing examples, as employed by the regulation, are broad, but the intent is deemed to be clear. Basically, costs incurred in the establishment of a new stand of timber are to be capitalized. However, costs incurred in the preservation and improvement of an established stand of reproduction, whether of natural or artificial origin, may be either expensed or capitalized at the election of the owner as development costs.

Once the young stand is established, the costs of preservation or improvement are considered to be deductible items, subject to the election cited above. Such costs would include non-commercial thinning, pruning, girdling, or cutting of weed trees, release operations, or other silvicultural practices that promote growth. But, any incidental income from such operations is an offset to the expense.

By regulation, all capitalized costs allocated or charged to immature timber are recoverable only through depletion, casualty loss, or through gainful disposal.

CAPITAL GAINS TREATMENT

Under certain conditions income from the sale of timber or timber lands is subject to the capital gains provisions of the Internal Revenue Code of 1954 Sections 1.631a; 1.631b. Details of this are found in income tax Form T (Timber) available from the Internal Revenue Service. If income from timber qualifies, the income tax paid may be reduced considerably. It will pay you to check this.

